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Ms. Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Submitted electronically via www.sec.gov/rules/submitcomments.htm

August 16, 2022

Dear Ms. Countryman,

Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices (File No. S7–17–22)

The Alternative Investment Management Association (AIMA)[1] appreciates the opportunity to comment on the U.S. Securities and Exchange Commission's (SEC or Commission) proposed rule[2] on "Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices" (the Proposed Rule).

Environmental, social and governance ("ESG") investing - and responsible investment more broadly - are prominent topics in the investment management industry, reflecting the significant investor

[1] AIMA, the Alternative Investment Management Association, is the global representative of the alternative investment industry, with around 2,100 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2.5 trillion in hedge fund and private credit assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programs and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 250 members that manage $600 billion of private credit assets globally. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialized educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors). For further information, please visit AIMA's website, www.aima.org.
[2] SEC, Proposed Rule: "Enhanced Disclosures by Certain Investment Advisers and Investment Companies About Environmental, Social, and Governance Investment Practices", 87 Fed. Reg. 36654 (June 17, 2022).

appetite for investment products that effectively manage risk or achieve real-world impact. AIMA's members continue to refine their approaches to ESG risks, using a sophisticated set of tools and techniques to deliver on their investors' expectations.

At a high level, we note that the SEC's proposed disclosure regime appears overly prescriptive and seems to focus more on standardization and comparability than on materiality. This approach will likely lead to less meaningful disclosure reflecting the restrictive structure of the rules, rather than leading to the outcome whereby a manager is able to accurately describe the way in which it uses the ESG factors that it considers to be material.

In responding to the Proposed Rule, we make the following points:

- We believe that the Commission's envisaged corporate climate risk reporting rules should be finalized before contemplating distinct ESG disclosures for investment advisers. Furthermore, reporting on greenhouse gas (GHG) emissions should not be required of funds and/or advisers until associated corporate reporting is live and tested.

- We question the Commission's approach of basing its disclosure framework around the categories of "ESG integration fund", "ESG-focused fund" and "impact fund" as described in the Proposed Rule: we do not believe that these are concepts that are universally understood or established in the dialog between investors and investment managers, such that mandating their use risks creating confusion on the part of investors. In addition, the implication of this from a compliance perspective is that managers could ultimately redirect compliance efforts to focus on ESG aspects of their operations or investment process, given the associated enforcement risk, even in the absence of meaningful greenwashing risks.

- It is also worth keeping in mind that regulation itself – even if intended to mitigate greenwashing risk – can in fact amplify this risk, particularly if regulation is based on unclear product boundaries or classification systems.

- We believe that the Commission should at a minimum:

    - Remove the "ESG integration" category; and

    - Make the "ESG-focused" category more targeted so that it applies to a smaller range of products that have a much more meaningful ESG focus than currently envisaged.

- In the context of disclosures related to GHG emissions, we believe that the Commission's stance that short positions "may not offset the transition risk expressed by the fund's WACI [weighted average carbon intensity]" fundamentally overlooks the potential role of short positions in hedging against unwanted climate risk. We instead believe that, at a minimum, disclosure of both long and short GHG exposures should be provided allowing investors to analyse the data in the way they prefer.

We would be happy to elaborate any of the points raised in this letter. For further information, please contact Adam Jacobs-Dean, Global Head of Markets, Governance and Innovation, by email at ajacobs-dean@aima.org.

Yours sincerely,

/s/

Jiří Król
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AIMA

ANNEX

1. Rulemaking concerning investment advisers' ESG approaches is premature

We have previously submitted comments in respect of the Commission's proposed rule that would amend its rules under the Securities Act of 1933 (Securities Act) and Securities Exchange Act of 1934 (Exchange Act) to require registrants to provide certain climate-related information in their registration statements and annual reports.[3]

In responding, we noted that our members are increasingly focused on the management of the climate-related risks to which their investments are exposed and are heavily reliant on the availability of consistent and comparable corporate disclosures to be able to analyze and manage those risks. We agreed with the Commission's analysis that there is presently considerable variation in the content, detail, and location of climate-related disclosures, as well as significant inconsistency in the depth and specificity of those disclosures.[4] This can make it significantly more challenging for investors to meaningfully understand an investee company's exposure to climate risks, which could ultimately harm the effectiveness of investment decision-making.

We therefore very much welcome the Commission's proposal to require registrants to provide certain climate-related information in their registration statements and annual reports, while emphasizing the importance of quality of data over the quantity of data. This will provide additional material information to our member base, ensuring that they can best serve the needs of their ultimate end investors, which include endowments, charities and pension funds.

We are concerned, however, that the Commission is now moving ahead with proposals relating to ESG disclosures by investment advisers prior to finalization of corporate climate reporting requirements, given that the ability of advisers to report meaningfully on their approach to climate risk is contingent on the availability of associated corporate data made available by registrants in their registration statements and/or annual reports.

Ideally, we believe that the envisaged corporate climate risk reporting rules should be finalized before contemplating distinct ESG disclosures for investment advisers. Furthermore, reporting on GHG emissions should not be required of funds and/or advisers until associated corporate reporting is live and tested (ideally by way of two complete reporting cycles), given that this is a key data input needed by advisers and funds that they sponsor.

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[3] SEC, Proposed Rule, The Enhancement and Standardization of Climate-Related Disclosures for Investors, 87 Fed. Reg. 21334 (Apr. 11, 2022).

[4] 87 Fed. Reg. 21339.

2. The proposed categorization framework for investment products is unworkable

In the Proposed Rule, the Commission notes that:

> *"investment product that incorporate one or more ESG factors vary in the extent to which ESG factors are considered relative to other factors. This generally falls along a three-part spectrum: integration; ESG-Focused, and impact investing. We are incorporating these terms into our proposed rules."* [5]

It is common in the literature on ESG investing to present the different possible approaches in the form of a spectrum, typically with a focus on the extent to which the applicable approach is oriented towards improving risk/returns (at one end of the spectrum), taking advantage of ESG opportunities, or achieving impact (at the other end of the spectrum).[6] However, it is important to note that these categorization frameworks are largely hypothetical and use distinct terminology and categories depending on how they are organized. This reflects the reality that ESG approaches depend to a large extent on the specific investment strategy of the investment manager or fund in question, something that is central to the debate about how to effectively implement responsible investment techniques in the context of alternative investments (we return later to specific aspects of this, including the treatment of short positions).

We therefore question the Commission's approach of basing its disclosure framework around the categories that are described in the Proposed Rule: we do not believe that these are concepts that are universally understood or established in the dialog between investors and investment managers.

Indeed, there are a number of more specific problems that we identify in the context of the proposed categories:

- **Consideration of ESG issues is arguably universal:** The Proposed Rule suggests[7] that the "ESG integration" concept would cover strategies that "consider one or more ESG factors alongside other, non-ESG factors in investment decisions [...]. In such strategies, ESG factors may be considered in the investment selection process but are generally not dispositive compared to other factors when selecting or excluding a particular investment." We believe that this approach would make this category unduly expansive: arguably all investment strategies include a degree of consideration of ESG factors, noting that consideration of company governance arrangements has long been a major consideration in the context of corporate investments, long before the concept of ESG investing gained prominence.

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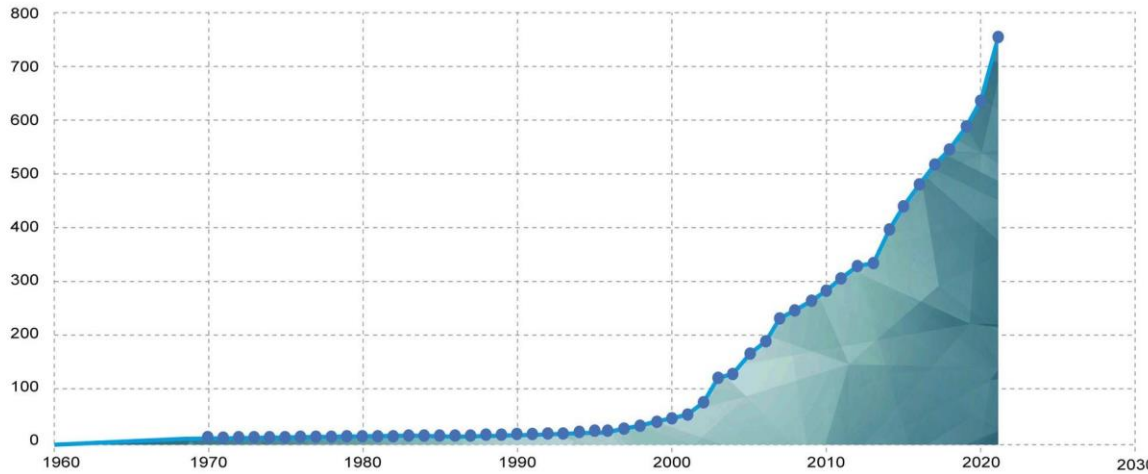
[5] 87 Fed. Reg. 36657.

[6] Principles for Responsible Investment, "Understanding the impact of your investments: Measuring environmental and social performance" (2013). Online at: https://www.unpri.org/thematic-and-impact-investing/understanding-the-impact-of-your-investments/141.article.

[7] 87 Fed. Reg. 36657.

It is also worth considering that regulation in the US[8] and abroad[9] is increasingly requiring financial market participants to consider ESG factors as a baseline requirement. Indeed, data from the PRI illustrates[10] this trend of increasing policy interventions targeting ESG issues.

Cumulative number of policy interventions (counting new policies and policy revisions)



Accordingly, is it likely that the "ESG integration" concept would be extremely wide in its reach, capturing products that do not in any way seek to distinguish themselves to investors based on their ESG characteristics. The associated concern from an investor standpoint is that using the concept of "ESG integration" in the context of required investor disclosures could create a perception that a given product does more to address ESG issues than is actually the case and in fact, may lead investors to believe that such product has received SEC's imprimatur. In addition, we believe the "ESG integration" concept is also in direct conflict with SEC proposal on fund names ("Names Rule Proposal").[11] While this comment letter does not address the Names Rule Proposal, we would like to point out that under the Names Rule Proposal, the Commission would define the names of "integration funds" as materially deceptive or misleading if the name indicates that the fund's investment decisions incorporate one

[8] See, for example, U.S. Department of Labor, Proposed Rule, Prudence and Loyalty in Selecting Plan Investment and Exercising Shareholder Rights, 86 Fed. Reg. 57272 (Oct. 14, 2021).
[9] See, for example, Commission Delegated Regulation amending Delegated Regulation (EU) No 231/2013 as regards the sustainability risks and sustainability factors to be taken into account by Alternative Investment Fund Managers. Online at: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=PI_COM:C(2021)2615.
[10] PRI, "What is responsible investment?". Online at: https://www.unpri.org/an-introduction-to-responsible-investment/what-is-responsible-investment/4780.article. The PRI notes: "Since the mid-nineties, responsible investment regulation has increased significantly, with a particular surge in policy interventions since the 2008 financial crisis. Regulatory change has also been driven by a realisation among national and international regulators that the financial sector can play an important role in meeting global challenges such as climate change, modern slavery and tax avoidance."
[11] SEC, Proposed Rule, Investment Company Names, 87 Fed. Reg. 36594 (Jun. 17, 2022) .

or more ESG factors. As a result, we believe the position taken in the Names Rule Proposal supports our comment that the concept of "ESG integration" would create a perception that a given product does more to address ESG issues than actually is the case.

For these reasons, we do not believe that the Commission should use the "ESG integration" concept if it ultimately adopts a product categorization framework.

- **The use of screens is not a meaningful signifier of ESG status**: In the Proposed Rule, the Commission suggests that "ESG-focused" strategies would be those that "focus on one or more ESG factors by using them as a significant or main consideration in selecting investments or in engaging with portfolio companies".[12] It goes on to suggest that the definition would include funds that "apply a screen to include or exclude investments in particular industries based on ESG factors".[13]

  We believe that this overlooks the fact that largely generic, norms-based screens are extremely common in the investment management industry. For example, many of our members have in place a firm-wide exclusion policy that restricts investment in "controversial weapons", described as those that are either: (1) illegal on account of their production and use being prohibited by international legal instruments; or (2) considered controversial because of their indiscriminate effects and the disproportionate harm they may cause. The most common exclusion relates to cluster munitions, with landmines the next most common exclusion. Depending on its sectoral focus, such screens do not necessarily have a significant impact on the investment universe of a given fund.

  As such, we believe that the bar for what constitutes an ESG-focused product has been set too low. We believe the Commission should rethink its stance on inclusionary and exclusionary screens such that an investment strategy would only be categorized as ESG-focused if inclusionary or exclusionary screens play a material role in the adviser's portfolio construction for such investment strategy.

- **Proxy voting on ESG issues is not a meaningful signifier of ESG status:** In the Proposed Rule, the Commission suggests that if proxy voting or engagement with issuers is a"significant" means of implementing the fund's ESG strategy then such a fund must identify itself as such.

  Again, we do not believe that this necessarily distinguishes a fund as having a particular ESG focus, given that engagement and proxy voting are broadly practiced across the investment management industry and will often address issues that could be described as relating to ESG concerns, given the ultimate breadth of what this could encompass.[14] The Commission should,

[12] 87 Fed. Reg. 36657.
[13] 87 Fed. Reg. 36662.
[14] We note that many jurisdictions have requirements that mandate the exercise of voting rights to a degree (cf. the UK's Stewardship Code or European Union's Shareholder Rights Directive).

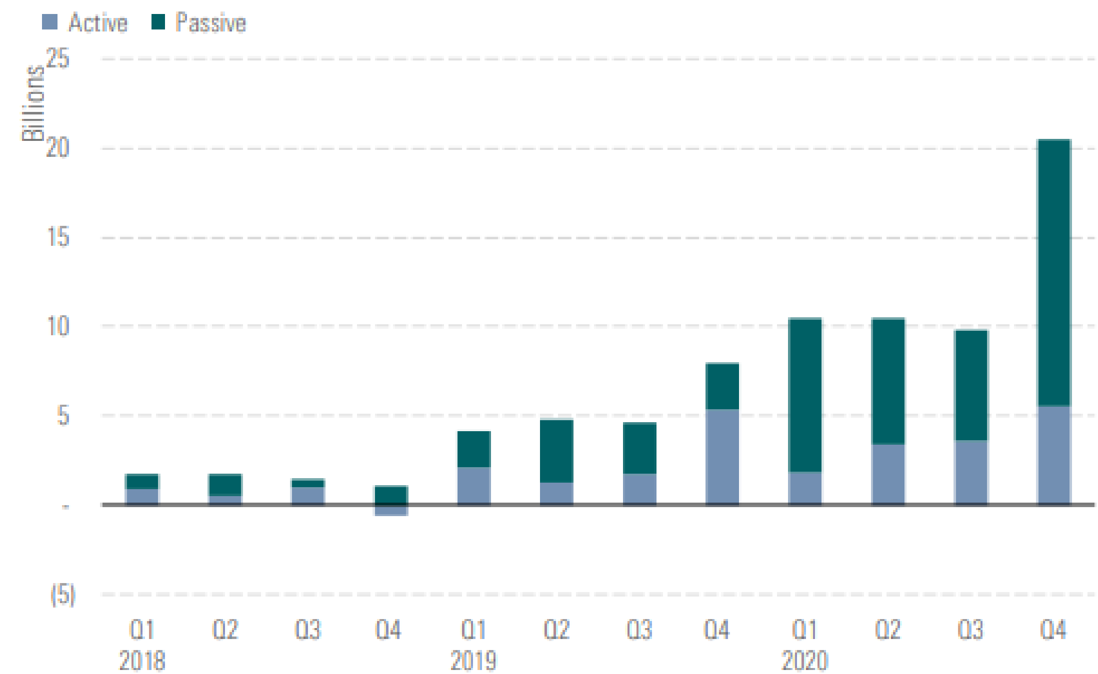
instead, provide that simply exercising its right to vote would not constitute a "significant" means of implementing a fund's ESG strategy. Moreover, if neither proxy voting or direct engagement is a significant means of implementing a fund's strategy, no further disclosure should be required. We believe that requiring funds to affirmatively state that they do not engage in proxy voting would only lead to additional costs (and in some instances duplicative costs), and is unnecessary because proxy voting information can already be found in other regulatory filings (e.g., Form N-PX).

As noted previously, we believe that the bar for what constitutes an ESG-focused product has been set too low and we believe the Commission should rethink its stance on proxy voting.

- **Poorly defined categories will create greenwashing risks**

  As a broader consideration, it is worth noting that ESG or sustainability status has become an important consideration for many investors and allocators when deciding how to invest. While this trend is less well established in the US relative to other jurisdictions, notably Europe, it is highly likely that ESG investing will continue to gain in prominence in the US market – as illustrated in the chart below - particularly if the Commission implements rules that require explicit disclosures regarding the ESG characteristics of a product.

US Sustainable Fund Flows ($bn) [15]



Source: Morningstar Direct, Manager Research. Data as of December 2020.

This demand for ESG-oriented products inevitably creates the potential for greenwashing risks. However, it is also worth keeping in mind that regulation itself – even if intended to mitigate this risk – can in fact amplify this risk, particularly if regulation is based on unclear product boundaries or classification systems.

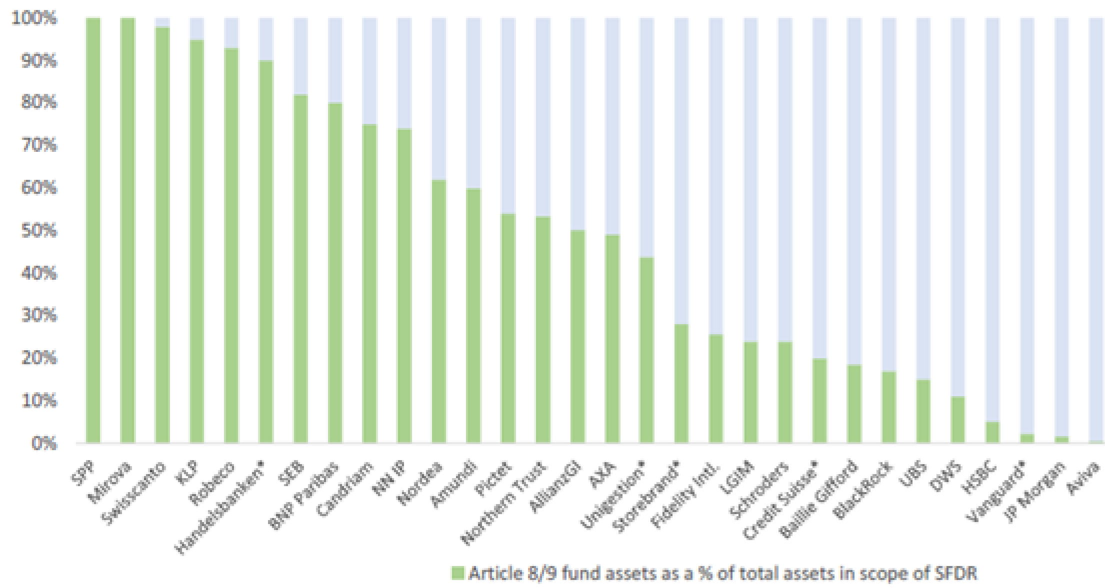
This is very much apparent in the context of the EU's Sustainable Finance Disclosures Regulation (SFDR).[16] This includes differentiated product disclosure rules for products that "promote environmental or social characteristics" (so-called Article 8 products) and products that "have sustainable investments as their objectives" (so-called Article 9 products). Given the inherent vagueness in these terms, and implicit asset raising incentives associated with a product that is designated as being an Article 8 or Article 9 product, there is an extremely wide

[15] ESG Clarity, "Global sustainable fund flows soared to 'stratospheric heights' in Q4" (February 2021). Online at: https://esgclarity.com/global-sustainable-fund-flows-soared-to-stratospheric-heights-in-q4/.

[16] Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector.
Online at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R2088&from=EN.

dispersion in the approach taken by individual firms to how they categorize their product set, as illustrated[17] by Morningstar data:

Article 8 and 9 Fund Assets as a Percentage of Total Assets in Scope of SFDR



Source: Asset Managers. (*) Estimated using Morningstar Direct Data as of March 2020.

This suggests that investors might struggle to make meaningful comparisons between the ESG credentials of different products, given that regulatory ambiguity has led individual managers to take divergent stances on classifying their product set. In the extreme, this regulatory ambiguity could lead to greenwashing, with the potential for firms to position products in a way that overstates their ESG characteristics.

Therefore, in summary, we believe that the Commission should at a minimum:

- Remove the “ESG integration” category; and
- Make the “ESG-focused” category more targeted so that it applies to a smaller range of products that have a much more meaningful ESG focus than currently envisaged.

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[17] ESG Clarity, “SFDR: Which groups have the most Article 8/9 funds?” (April 2021). Online at: https://esgclarity.com/sfdr-which-groups-have-the-most-article-8-9-funds/.

3. **The Commission's approach to short positions overlooks their potential in the context of reducing exposure to climate risk**

AIMA has previously explored[18] how short selling in particular can be an excellent tool for achieving two common goals of contemporary responsible investment: mitigating undesired ESG risks, and, when taken in aggregate, creating an economic impact by influencing the nature of capital flows through 'active' investing.

In our prior work, we used the example of carbon footprinting to illustrate how investment managers could use short selling to limit their exposure to carbon risks. We also acknowledged that investors might be interested in the carbon footprint of a portfolio not just for the sake of gauging its carbon risk, but also to measure the degree to which it is funding carbon emissions. We suggested that managers would need to determine a way of communicating the fact that they may be providing funding to carbon emissions with their long positions, while arguably increasing the cost of equity capital for other carbon emitters through their short positions.

We therefore are concerned by the Commission's stance on disclosure of GHG emissions metrics in the annual reports of ESG-focused Funds that consider environmental factors. Specifically, we do not agree with the envisioned approach that:

> "if a fund engages in a short sale of a security, the proposed requirements do not include a provision that would permit the fund to subtract the GHG emissions associated with the security from the GHG emissions of the fund's portfolio that are used to calculate the fund's WACI or carbon footprint. A short sale would allow the fund to profit from a decline in value of the security, but would not reduce the extent of the fund's financed emissions and may not offset the transition risk expressed by the fund's WACI." [19]

We believe this fundamentally overlooks the potential role of short positions in hedging against unwanted climate risk and instead believe that, at a minimum, disclosure of both long and short GHG exposures should be provided allowing investors to analyse the data in the way they prefer.

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[18] AIMA, "Short selling and responsible investment" (September 2022). Online at: https://www.aima.org/static/8eac1e4b-e7d1-42c0-baebdf4a3bc8540a/1772020-AIMA-Short-Selling-and-Responsible-Investment-V6-4.pdf.
[19] 87 Fed. Reg. 36679.

4. <u>Linking the guidance relating to compliance policies, procedures and marketing to the proposed ESG categorization framework will lead to compliance resource being poorly allocated</u>

We note that the Proposed Rule reaffirms the Commission's expectation that "as with all disclosures, advisers' and funds' compliance policies and procedures should address the accuracy of ESG-disclosures made to clients, investors and regulators".[20]

We endorse this stance as a matter of principle, noting that ESG concerns are already addressed by the general compliance rule and anti-fraud provision of the Investment Advisers Act. We are, however, concerned that, if adopted, the Commission's proposed fund classification framework could make it difficult or impossible for advisers to fulfill these expectations without effectively exaggerating the centrality of ESG issues, to the detriment or exclusion of other important compliance tasks.

In effect, the risk is that the requirement to use ESG terminology that is overly broad in its application will result in managers redirecting compliance efforts towards certain practices that have an ESG component, given the associated enforcement risk, even in the absence of a meaningful risk of greenwashing in terms of how the product was originally designed and marketed.

This for us further justifies the need to reassess the proposed fund categorization to ensure that it is appropriately targeted in its application.

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[20] 87 Fed. Reg. 36696.